DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: July 2, 2008
POSITION: Neutral

BILL NUMBER: AB 3078
AUTHOR: Assembly Revenue and Taxation

SPONSOR: Franchise Tax Board

BILL SUMMARY: PIT/CIT: Tax Administration: Nonresidents

This bill would (1) allow specified entities to file a tax return on behalf of certain nonresidents, (2) close loopholes on the payments nonresident and non-California businesses receive from the sale of California property, (3) extend the statute of limitations for claiming credits on out of state taxes paid, (4) increase the Personal Income Tax (PIT) estimated tax penalty threshold, (5) clarify rules for the elimination of income of specified dividends received, (6) provide relief to taxpayers in cases where the Franchise Tax Board (FTB) erroneously applied penalties, fees, or interest.

FISCAL SUMMARY

The FTB estimates that the combined provisions of this bill would result in PIT General Fund loss of $50,000 in 2007-08, followed by PIT and Corporate Income Tax General Fund revenue gains of $9 million in 2008-09, $7.3 million in 2009-10, and $7.4 million in 2010-11. Additionally, the Mental Health Services Fund (MHSF) would see increases of $3 million in 2008-09, $7 million in 2009-10, and $8 million in 2010-11.

The FTB estimates that implementing the provision to modify group returns would result in one-time costs of $101,000. All other provisions of this bill would not significantly impact the FTB costs.

COMMENTS

The Department of Finance is neutral on this bill.

- This bill would increase General Fund and MHSF revenues.
- This bill makes filing state tax returns easier for nonresidents while ensuring that tax due the state from certain nonresidents and businesses is collected.
- This bill closes tax loopholes for nonresident individuals and nonresident businesses owing tax on California property sold.
- This bill provides tax relief where penalties, fees, or interest were imposed on a taxpayer in instances that the FTB has taken erroneous action, inaction, or caused delay.
- This bill clarifies state income tax law related to treatment of dividends received.

MANDATE DISCUSSION: Provision closing loopholes in real estate withholding for nonresidents.

After consulting with Finance's Mandates Unit, it does not appear there is a reimbursable mandate associated with this bill. Although this bill is denoted as a state-mandated local program, the bill has no other requirements of local agencies except for the enforcement of the expanded scope of the existing crime of perjury related to withholding. This bill modifies existing income tax withholding requirements by (1) including sellers that are non-California partnerships and (2) by requiring a certification under penalty of perjury for alternative withholding from those partnerships.

Analyst/Principal	Date	Program Budget Manager	Date
(0723) C. Angaretis		Mark Hill	

Department Deputy Director	Date

Governor's Office:	By:	Date:	Position Approved_______
			Position Disapproved

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ANALYSIS

A. Programmatic Analysis

This bill would become effective January 1, 2009.

1. Group nonresident returns (operative for returns filed on or after January 1, 2010).

Existing state law imposes tax on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

Existing state law allows certain nonresidents who receive a share of income from a pass-through entity (e.g., partnerships or S corporations) that derives income from California sources or is doing business in California to elect to have the pass-through entity file a group nonresident return on their behalf. In addition, California allows filing of a group nonresident return for electing nonresident directors of a corporation. Nonresident group returns are automatically taxed at the highest marginal rate of 9.3 percent.

Under existing state law, and instructions specifically prescribed by FTB, all of the following conditions must be met to be eligible for inclusion in a group nonresident return:

- The taxpayer must be an individual. Estates, trusts, partnerships, LLCs, C corporations, S corporations, or other business entities cannot be included in the group nonresident return.
- The individual must be a full-year nonresident of California.
- The individual must not have California taxable income in excess of $1 million.

The nonresident return must include at least two electing nonresidents, except in the case of an S corporation which may file a group nonresident return on behalf of one shareholder. A nonresident individual can be included on more than one group nonresident return.

Existing state law provides for a one-percent mental health tax on income over $1 million (Proposition 63, 2004). The revenue from this tax provides a dedicated funding source for the expansion of mental health treatment options. Nonresidents subject to the mental health tax are ineligible to be included in a group nonresident return.

This bill would amend current law to allow entities with less than two electing nonresident individuals and individuals with more than $1 million in California taxable income to be included in a group nonresident return.

(Note: Under current law, the one-percent MHSF tax is not applied to group returns as nonresidents with income above $1 million may not file a group return. The tax rate currently applied to group returns is the top marginal rate of 9.3 percent. This bill would allow nonresident taxpayers with incomes above $1 million to file in a group return. Therefore, the top marginal tax rate of 10.3 percent would be applied to these individuals who qualify to pay the MHSF tax. All other individuals within the group would be subject to the 9.3 percent rate.)

2. Closing loopholes in real estate withholding for nonresident taxpayers.

Current state law requires income tax withholding on the sale of real property at source from payments to nonresident individuals and business entities (excluding partnerships) with no permanent place of business in California.

For S corporation sellers of California real property, California taxes the gain from that sale twice. First, the gain is taxed under the corporate franchise tax at the S corporation entity-level rate. Second, the income from the sale that is passed through to the shareholders as their pro-rata share is taxed to the shareholder at the personal income tax rate.

Under current state law, real property that qualifies as an “installment sale” under the Internal Revenue Code (IRC) allows the buyer to elect to withhold on each of the installment payments over the life of the installment contract, rather than withholding and remitting the entire withholding amount at the time of sale. An installment sale is a sale of property at a gain where at least one payment is to be received after the tax year in which the sale occurs.

This bill would require non-California partnerships to be subject to withholding on California real property sales at a rate of 3-1/3 percent of sales proceeds or 9.3 percent of gain.

This bill would specify, for S corporations, that the entity-level and pass-through withholding rates be combined to determine the alternative withholding rate to be applied to the gain on the sale.

This bill would require the buyer to withhold on each installment sale payment if the sale is structured as an installment sale.

This bill would clarify that withholding amounts can be collected from the withholding agent if the agent fails to withhold or fails to remit the withheld amounts to the FTB.

3. Revising limitations for other state tax credit (OSTC) claims for credit or refund.

Under current state law, no credit or refund is allowed after four years from the original due date of the return, four years from the date the return was filed (if filed within the extension period), or one year from the date of the overpayment, whichever is later, unless a claim for refund is filed by the taxpayer.

This bill would revise the statute of limitations period for claiming an OSTC to be the later of the normal limitations period or one year after the taxpayer pays tax to the other state.

4. Taxpayer advocate equity relief (operative for consideration requests to Taxpayers' Rights Advocate that are received on or after January 1, 2009, irrespective of the tax year involved).

Under current federal law, the Internal Revenue Service (IRS) has authority to abate any unpaid portion of tax, liability, or interest tax assessed by the IRS in error. The IRS is required to suspend interest on any amounts owed if the IRS fails to provide a notice to the taxpayer stating the amount owed and the basis of the amount owed within 18 months from when the return was filed.

Current state law allows FTB staff to abate penalties, fees, additions to tax, or interest under specific circumstances. These include delay or errors by the FTB or IRS, instances of financial hardship, or instances of reasonable cause exceptions.

Current state law creates the Taxpayers' Rights Advocate who reports directly to the Executive Officer of the FTB and is responsible for coordinating the resolution of taxpayer complaints and problems. The Taxpayers' Rights Advocate is empowered to review actions taken on a taxpayer's account and take prompt action including placing a hold on actions where a taxpayer has suffered or will suffer irreparable loss from the board action.

This bill would expand the responsibility of the Taxpayers' Rights Advocate to include resolution of taxpayer issues identified by FTB employees.

This bill would authorize the Taxpayers' Rights Advocate to waive penalties or additions to tax, fees, and interest that are attributable to erroneous action or erroneous inaction by the FTB in processing documents filed or payments made by a taxpayer, unreasonable delay caused by the FTB, or erroneous written advice that did not qualify for relief under Chief Counsel of the FTB's authority. Advocate orders for relief cannot be reviewed in any judicial or administrative proceeding.

This bill would require the Chief Counsel of the FTB to concur with the decision to grant relief when the total reduction in penalties, fees, additions to tax, or interest exceeds $500. This threshold amount is to be adjusted by the FTB annually by the change in the California Consumer Price Index. Relief at any level would require a public record to be placed in the office of the Executive Officer of the FTB that includes the following information:

- The taxpayer's name.
- The total amount involved.
- The amount payable or refundable due to the error or delay.

- A summary of why the relief is warranted.

This bill would require the Taxpayers' Rights Advocate to include in its annual report to the Legislature a summary of the instances where relief was granted, the nature of the error or delay, and the steps taken by the department to remedy systemic issues that required relief.

5. Increase the PIT estimated tax penalty threshold (operative for taxable years beginning on or after January 1, 2010).

Current federal personal income tax law requires estimated tax payments if both the tax is expected to be at least $1,000 after subtracting withholding and credits, and if withholding and credits are expected to be less than the smaller of 90 percent of current year's tax or 100 percent of prior years' tax. For any PIT underpayment of estimated tax, a penalty equal to the current interest rate is assessed on the underpaid amount for the period of underpayment.

Current state law generally conforms to federal law and requires estimated tax payments if both the tax is expected to be at least $200 ($100 if married/RDP filing separate) after subtracting withholding and credits, and if withholding and credits are expected to be less than the smaller of 90 percent of current years' tax, or 100 percent of prior years' tax.

State law also provides an exception to the penalty. If the total tax after application of credits is less than $200 ($100 if married/RDP filing separate) for the preceding or current taxable year, a penalty is not assessed.

This bill would increase the threshold for imposing the estimated tax penalty from $200 ($100 if married/RDP filing separate) after subtracting withholding and credits to $500 ($250 if married/RDP filing separate).

(Note: The Legislature did not include a proposed amendment by the FTB in the June 19th version to specify the operative date of the tax penalty threshold as January 1, 2009. This simply delays the associated revenue loss from 2008-09 to 2009-10.)

6. Rules for the elimination from income of certain dividends received.

Under federal law, a group of affiliated corporations may elect to file a single tax return called a consolidated tax return. In general, if a corporation owns at least 80 percent of another corporation or of multiple corporations, those corporations are considered an affiliated group and can file a consolidated tax return.

A dividend is the method which a corporation distributes its earnings to shareholders. Dividends received by taxpayers are included in income.

Dividends are allowed to be eliminated from the income of a recipient (payee) if at the close of the day on which the dividend is received the payor and payee are members of the same affiliated group.

A federal regulation also provides relief for dividends paid between a member of an affiliated group and a newly organized holding company of the group.

Under current state law, a group of affiliated corporations (which is determined under state law using a more than 50 percent, rather than 80 percent, ownership test) is referred to as a "commonly controlled group." Corporations in a "commonly controlled group" that meet certain requirements must file on a combined basis if they are part of a unitary business.

Current state law provides that dividends paid by one member of a combined unitary group out of "income previously described of the unitary business" to another member of the group are eliminated from the recipient's taxable income. The intent of the elimination is to prevent including the same income twice in determining the tax base of the unitary group return.

According to the FTB, the literal reading of current law's dividend elimination statute could be interpreted to mean the payor and/or payee must be California taxpayers before the payee may eliminate dividends received from the payor. FTB staff also view the current dividend elimination statute unclear as to whether earnings and profits, accumulated when the payor and payee were members of a combined group taxable only outside of California, would be used in the calculation of dividend elimination.

This bill would conform existing law to the department's practice that if dividends are paid from income earned in years prior to the payor and payee becoming members of a California combined group filing, dividend elimination would be allowed if the earnings and profits are from a return filed on a comparable combined unitary basis in another state that included the payor and payee.

This bill would permit the FTB to deny dividend elimination in cases where transactions or business structures are set up with the purpose of evading tax.

This bill would allow the FTB to adopt regulations in order to carry out the intended purpose of dividend elimination, which is to prevent taxation of dividends received by a member of a unitary group where those dividends were paid from income previously described of the unitary business by another member of the same unitary group.

B. Fiscal Analysis

General Fund revenues:

	(Dollars in Millions)		
Tax Provision:	2008-09	2009-10	2010-11
1. Group nonresident returns (a)	$2.0	$6.0	$6.0
2. Closing loopholes in real estate withholding	$7.6	$3.05	$2.8
3. Revising limitations for other state tax credit	-$0.2	-$0.8	-$0.8
4. Taxpayer advocate equity relief (b)	-$0.05	-$0.05	$0
5. Increase PIT penalty threshold (c)	$0	-$0.5	-$0.2
6. Dividend elimination rules change	-$0.4	-$0.4	-$0.4
Total General Fund Revenue Gain	**$8.95**	**$7.30**	**$7.40**

(a) Estimated 2008-09 one-time implementation cost of $101,000.
(b) Estimated 2007-08 revenue loss of $50,000.
(c) According to the FTB, although this provision results in a net revenue loss, it would save resources for the taxpayers and tax professionals who currently respond to small-dollar penalty notices. The decision to recommend raising the threshold was partly based on taking into consideration the argument made by taxpayers and tax professionals that the time it takes to respond to these penalty notices was excessive for the small-dollar amounts of penalties being assessed.

Mental Health Services Fund revenues:

	(Dollars in Millions)		
Tax Provision:	2008-09	2009-10	2010-11
1. Group nonresident returns (a)	$3.0	$7.0	$8.0

a) According to the FTB, MHSF revenue increases would be due to (1) new filers, (2) current separate filers who will opt to file a group return for convenience but would lose deductions, exemptions, or credits they currently receive, and (3) a reduction in the number of taxpayer's who should be currently subject to the MHSF tax, but are filing in group returns erroneously.

The FTB estimates that the combined provisions of this bill would result in PIT General Fund loss of $50,000 in 2007-08, followed by PIT and Corporate Income Tax General Fund revenue gains of

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$9 million in 2008-09, $7.3 million in 2009-10, and $7.4 million in 2010-11. Additionally, the MHSF would see increases of $3 million in 2008-09, $7 million in 2009-10, and $8 million in 2010-11.

The FTB estimates that implementing the provision to modify group returns would result in one-time costs of $101,000. All other provisions of this bill would not significantly impact the FTB costs.

The FTB believes that increasing the estimated tax penalty threshold would result in costs savings of $91,300 due to a reduction in the number of assessed penalties, and subsequently, a reduction in associated mailings, printings, personnel, correspondence, and payment processing costs.

Code/Department Agency or Revenue Type	SO LA CO RV	PROP 98	FC	(Fiscal Impact by Fiscal Year) (Dollars in Thousands) 2008-2009	FC	2009-2010	FC	2010-2011	Fund Code
1147/Pers Inc Tax	RV	Yes	U	$7,950	U	$6,300	U	$7,000	0001
1147/Pers Inc Tax	RV	No	U	$3,000	U	$7,000	U	$8,000	3085
1730/FTB	SO	No	C	$101		--		--	0001
1104/Corp Tax	RV	No	U	$1,000	U	$1,000	U	$400	0001

Fund Code	Title
0001	General Fund
3085	Mental Health Services Fund